

# IRC §42, Low-Income Housing Credit - Part VIII Other Topics

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## Chapter 19 Auditing Partners

### Introduction

The computation of the allowable IRC §42 credit is not solely dependent on the amount reported as a flow-through item from the partnership owning the IRC §42 project. The allowable credit is also subject to limitations at the partner level.

### Topics

- Claiming the IRC §42 Credit
- Required Filing Checks
- IRC §6222, Consistent Treatment of Partnership Items
- IRC §38(d), Ordering Rules
- IRC §39, Carryback and Carryforward of Unused Credits
- IRC §469, Passive Activity Limitations
- IRC §55, Alternative Minimum Tax
- Flow-Through Adjustments from Partnership Audits: Current Year Adjustments
- Flow-Through Adjustments from Partnership Audits: The Recapture Amount
- Disposition of Interest in Partnership Owning IRC §42 Project
- Summary

## **Claiming the IRC §42 Credit**

### **Form 8586, Low-Income Housing Credit**

Form 8586, Low-Income Housing Credit, is filed with the taxpayer's tax return to claim the credit. The allowable credit flowing through is reported on line 4 of Part I or line 11 of Part II, depending on when the low-income buildings were placed in service.

### **Form 3800, General Business Credit**

The IRC §42 credit is included in the General Business Credit under IRC §38(b) (5). The allowable IRC §38 business credit is calculated on Form 3800, General Business Credit. The reporting of the IRC §42 credit depends on when the low-income buildings were placed in service.

For buildings placed in service before January 1, 2008, the credit is reported in Part I.

For buildings placed in service after December 31, 2007, the credit is reported in Part II.

## **Required Filing Checks**

### **Audit Requirements**

If the taxpayer owns an interest in an IRC §42 project, directly or indirectly through tiered partnerships, then the taxpayer and the partnerships are related and the taxpayer is subject to the Required Filing Checks as outlined in IRM 4.10.5.4.

### **Confirm Filing**

Confirm that the related partnership filed its tax return. No partnership items flowing through from the partnership are allowable if the partnership has not filed its tax return.

### **Consistent Treatment**

Confirm that the taxpayer has claimed the IRC §42 credit and other flow-through items as reported on the Schedule K-1 provided by the partnership.

### **Related Partnership is Under Audit**

Determine whether the partnership is currently under audit. Any pending adjustments at the partnership level may impact adjustments considered at the partner level.

### **Transactions Between Related Parties**

Taxpayers claiming the credit are usually limited partners that are not involved in the day-to-day operation of the IRC §42 project or partnership itself. However, depending on the relationship, there may be other transactions between the related parties to consider. For example:

- The taxpayer under audit is the IRC §42 partnership's general partner who has control of the partnership. Did the taxpayer also develop the IRC §42 project and receive a developer fee? If so, has the taxpayer properly reported the fee as income? Similarly, is the taxpayer managing the IRC §42 project and receiving a management fee? If so, is the taxpayer properly reporting the management fee?
- The taxpayer under audit is an intermediary tiered partnership. Did the taxpayer correctly report the amount of credit on the Schedules K-1 provided to its partners based on the Schedules K-1 it received?
- In addition to the capital contribution, did the taxpayer loan the partnership money, or has the partnership loaned funds to the taxpayer?

### **Large, Unusual, or Questionable Items**

Inspect the related taxpayer's tax return and evaluate large, unusual, and questionable items, such as the IRC §42 credit, for audit potential. This evaluation is independent of the taxpayer under audit.

### **Audit Techniques**

The following audit techniques should be used.

- Interview the taxpayer and ask about the taxpayer's involvement with the IRC §42 partnership. Specifically, other than its capital contribution, was the taxpayer involved in any other transactions with the partnership?
- Review the taxpayer's partnership agreement.
- When examining the taxpayer's books and records, consider the effect of items on related returns.

## **IRC §6222, Consistent Treatment of Partnership Items**

### **Law**

Under IRC §6222(a), a partner is required to treat partnership items the same way as the partnership treated the item. Under IRC §6222(c), if a partnership item is treated inconsistently on the partner's return, the IRS may assess any resulting deficiency without regard to the restriction on an assessment attributable to a partnership item under IRC §6225.

IRC §6231(a)(3) defines a partnership item as any item required to be taken into account for the partnership's taxable year to the extent such item is more appropriately determined at the partnership level than at the partner level.

IRC §6231(a) (6) defines a computational adjustment as the change in the tax liability of a partner which properly reflects the treatment of a partnership item under the TEFRA. That is, a computational adjustment is the computation of a tax liability attributable to a partnership item.

### **"True-Ups"**

It is not unusual for taxpayers to hold ownership interests in multiple IRC §42 projects directly or through multi-tiered partnerships. Sometimes, if the Schedules K-1 are not received by the time the taxpayer files its tax return, the taxpayer will claim "estimated" losses and IRC §42 credit. The taxpayer does not always file Form 8082, Notice of Inconsistent Treatment, with its tax return to provide notice that partnership items on the tax return are inconsistent with the treatment of those items on the partnership return.

When the Schedules K-1 are received, the taxpayer will then reconcile the losses and credits claimed on its tax return with the amounts reported on the Schedules K-1. However, instead of filing an amended return to correct any discrepancy, the taxpayer will account for the discrepancy by adjusting the losses and credits claimed on its subsequent year tax returns. The adjustment is referred to as a "true-up" adjustment.

There are two primary issues:

- "True-ups" are allowable only to the extent the adjustment is made to report the correct allowable credit for that tax year; i.e., a computational adjustment under IRC §6231(a) (6). Refer to Field Service Advisory (FSA) 200125014 for additional discussion.
- "True-ups" of credits from year-to-year are not a permissible accounting method.

### **IRC §38(d), Ordering Rules**

Under IRC §446(a), taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. As explained in CCA 200812023, "IRC §42 tax credits must be allocated in the same proportion as the actual allocations of the related depreciation deductions giving rise to the credit for the year."

### **Law**

The IRC §42 credit is included under IRC §38 as a general business credit and is subject to the ordering rules under IRC §38(d). The ordering rules are important because taxpayers who invest

in IRC §42 projects are likely to invest in other credit programs such as the New Markets Tax Credit (IRC §45D) and Rehabilitation Credit (IRC §47). IRC §38(d) reads:

Ordering rules. For purposes of any provision of this title where it is necessary to ascertain the extent to which the credits determined under any section referred to in IRC §38(b) are used in a taxable year or as a carryback or carryforward—

(1) In general. The order in which such credits are used shall be determined on the basis of the order in which they are listed in IRC §38(b) as of the close of the taxable year in which the credit is used.

(2) Components of investment credit. The order in which the credits listed in IRC §46 are used shall be determined on the basis of the order in which such credits are listed in IRC §46 as of the close of the taxable year in which the credit is used.

The credit ordering rules are also important when applying the IRC §42(j) (4) (A) tax benefit rule; i.e., the recapture amount is calculated based on the credit used to reduce tax liability. This topic is addressed later in this chapter.

## **IRC §39, Carryback and Carryforward of Unused Credits**

IRC §39 accounts for allowable credit not used to reduce the taxpayer's tax liability for the current taxable year. IRC §38(a) provides that the allowable business credit is equal to the sum of:

- the business credit carryforwards carried to such taxable year,
- the amount of the current year business credit, plus
- the business credit carrybacks carried to such taxable year.

### **General Rule**

IRC §39(a) provides that if the sum of the business credit carryforwards and current year credit exceed the amount of the limitations imposed under IRC §38(c), then the excess credit is:

- a business credit first carried back to the taxable year preceding the unused credit year. For tax years beginning before January 1, 1998, the credit could be carried back 3 years.
- Any business credit not carried back is carried forward to each of the 20 taxable years following the year the credit was not used. For tax years beginning before January 1, 1998, the credit could be carried forward 15 years.

Under IRC §39(b) and (c), the IRC §38 ordering rules and limitation are applied when the credit is carried back or forward.

### **Transitional Rule**

Under IRC §39(d), the unused general business credit cannot be carried back to any taxable year before the first taxable year for which the specific credit listed in IRC §38(b) is allowable. For IRC §42, the credit was first allowable for the 1987 tax year.

## **IRC §469, Passive Activity Limitations**

The passive activity limitations under IRC §469(a)(2) apply to any individual, estate, trust, closely held C corporation, and any personal service corporation.

When an individual purchases an interest in a partnership, a limited liability company (LLC) treated as a partnership, or an S corporation, losses and credits may be limited by the passive activity limitation rules under IRC §469. Both passive losses and passive credits generated by rental activities are limited to the tax deduction equivalent of \$25,000. Passive losses are reflected on Form 8582, and passive credits are reflected on Form 8582-CR.

## **IRC §42 Losses**

Losses generated by IRC §42 projects are subject to the passive activity limitations. The taxpayer must actively participate to qualify for the \$25,000 offset. Furthermore, the \$25,000 amount is phased out at the rate of 50 cents for every dollar overmodified Adjusted Gross Income (AGI) of \$100,000. If modified AGI exceeds \$150,000, no losses may be deducted unless the taxpayer has passive income.

Since most individual investors are limited partners, and limited partners do not meet the active participation standard, losses generally should be entered on Form 8582, line 3b (not line 1b). Consequently, no \$25,000 offset is available and losses are deductible only to the extent of passive income reported on the return.

## **IRC §42 Credits**

IRC §469(i) (3) (D) and (6) (B) provide exceptions for IRC §42 credits; i.e., there is no active participation requirement for the \$25,000 offset and there is no phase-out of the credit based on modified Adjusted Gross Income. Therefore, a taxpayer may use the credit to offset taxable income subject to the \$25,000 limit. For example, the maximum IRC §42 credit allowable to a taxpayer in the 35% bracket is \$8,750.

The only reasons an individual could claim IRC §42 credit in excess of the tax deduction equivalent of \$25,000 are:

- There is tax attributable to net passive income on Form 8582-CR, line 6.
- The taxpayer is a real estate professional under IRC §469(c) (7) and materially participates in the rental real estate activity generating the low-income housing credits. For example, the taxpayer owns a construction company and works on the low-income housing project.

## **Only One \$25,000 Offset**

IRC §469(i) provides only one \$25,000 offset for losses and credits combined. The sum total of passive losses on Form 8582, line 10 and the credit equivalent on Form 8582-CR cannot exceed \$25,000 unless the taxpayer has passive income.

### **Ordering Rules**

Under IRC §469(i) (3) (E), the \$25,000 offset is absorbed first by passive losses, then by any passive activity credit, then by the rehabilitation credit, and finally by the low income housing credit. Passive losses and other passive credits are absorbed before the rehabilitation tax credit, which is absorbed before the IRC §42 credit.

If the \$25,000 offset is completely used up by passive losses, no low-income housing credit may be used. For example, if the taxpayer deducts \$25,000 in rental real estate losses under the provisions of IRC §469(i), no IRC §42 credit or any other passive credit may be used, unless the taxpayer has passive income. Similarly, if the taxpayer deducts \$20,000 in rental real estate losses, only the tax deduction equivalent of \$5,000 (approximately \$1,750 credit for someone in the 35% bracket) remains for passive credits.

### **Disposition of Passive Activity**

On disposition of a passive activity to an unrelated party in a fully taxable transaction, excess current and suspended losses are fully deductible (after having been subjected to basis and at-risk limitations). However, IRC §42 credits are not automatically allowable in full. Instead, the taxpayer has two choices:

- Under IRC §469(j)(9), the taxpayer may elect to increase the basis of the IRC §42 project (or an interest therein) by completing Form 8582CR, Part VI, or
- Under IRC §469(b), the taxpayer may continue to carry forward the credit. In which case, the credit is allowed to the extent of the tax equivalent of passive income (see IRC §469(d) (2)) and the credit is allowed to the extent of the \$25,000 offset (see IRC §§ 469(i) (1) and 469(i) (6) (B)).

### **Accounting for Passive Activity Limitations**

If the taxpayer is an individual, a personal service corporation, or a closely held C corporation, then the taxpayer must account for the passive activity limitations.

For individuals filing Form 1040 and the buildings were placed in service before January 1, 2008, the passive activity limitations are applied on Form 3800, Part I, lines 3 and 5. For buildings placed in service after December 31, 2007, the passive activity loss limitation is accounted for on Form 8582 and the passive activity credits on Form 8582-CR.

Personal service corporations and closely held C corporations file Form 8810, Corporate Passive Activity Loss and Credit Limitations. The passive activity credits are accounted for in Part II.

### **IRC §55, Alternative Minimum Tax**

## **Law**

IRC §55, Alternative Minimum Tax (AMT), is a tax equal to the excess (if any) of the tentative minimum tax for the taxable year, over the regular tax for the taxable year. The AMT computation is based on "alternative minimum taxable income," which is the taxpayer's taxable income for the year modified by adjustments provided for in IRC §§ 56 and 58 and increased by the amount of the items of "tax preference" under IRC §57.

IRC §38(c) (1) places a limit on the credit based on the amount of the tax liability. The allowable credit shall not exceed the excess (if any) of the taxpayer's net income tax over the greater of:

(A) the tentative minimum tax for the taxable year, or

(B) 25% of so much of the taxpayer's net regular tax liability as exceeds \$25,000.

## **Forms**

- Form 6251, Alternative Minimum Tax-Individuals, is used by individual taxpayers filing Form 1040 to compute the AMT amount.
- Form 4626, Alternative Minimum Tax-Corporations, is used by corporate taxpayers to compute the AMT amount. There is an exemption for small corporations under IRC §55(e).

## **Buildings Placed in Service Before January 1, 2008**

For buildings placed in service before January 1, 2008, the IRC §42 credit was subject to the limitations described in IRC §38(c) (1). The limitations were applied when computing the allowable credit on Form 3800, General Business Credit, and accounted for in Part I of the form.

## **Buildings Placed in Service After December 31, 2007**

Section 3022 of the Housing Assistance Tax Act of 2008 repealed the Alternative Minimum Tax limitations for the IRC §42 credit. IRC §38(c) (4) (A) now reads:

(4) Special rules for specified credits.

(A) In general. In the case of specified credits—(i) IRC §38 and IRC §39 shall be applied separately with respect to such credits, and

(ii) in applying IRC §38(c)(1) to such credits--(I) the tentative minimum tax shall be treated as being zero, and

(II) the limitation under IRC §38(c) (1) (as modified by subclause (I)) shall be reduced by the credit allowed under IRC §38(a) for the taxable year (other than the eligible small business credits and the specified credits).

IRC §38(c) (4) (B) (ii) specifies "the credit determined under IRC §42 to the extent attributable to buildings placed in service after December 31, 2007."

### **Form 3800, General Business Credit**

For taxable years ending in 2008 or later, Form 3800 accounts for AMT and the IRC §42 credit based on when the buildings were placed in service:

- For buildings placed in service before January 1, 2008, the credit continues to be accounted for in Part I.
- For buildings placed in service after December 31, 2007, the credit is accounted for in Part II.

### **Flow-Through Adjustments from Partnership Audits: Current Year Adjustments**

An adjustment to the credit at the partnership level will result in a parallel adjustment to the current year credit at the partner level, based on the partner's proportionate share of the related depreciation deduction or loss. See CCA 200812023. The adjustment will be composed of:

- Reduction of any carryforward of the credit to the subsequent year, and
- Disallowance of the current year credit.

#### **Example 1: Current Year Adjustment**

For 2010, the taxpayer's allowable IRC §42 credit from a partnership owning an

IRC §42 project was \$50,000. The taxpayer used \$35,000 to reduce its 2010 tax liability to zero. The taxpayer had already reduced its tax liability for 2009 to zero.

The remaining IRC §42 credit of \$15,000 was carried forward to 2011.

The partnership's 2010 return was audited and the allowable credit was reduced.

The taxpayer's corrected allowable IRC §42 credit from the partnership was 40,000.

The adjustment to the taxpayer's credit is \$10,000.

The \$10,000 adjustment is first applied against the \$15,000 carryforward, which is reduced to \$5,000. No adjustment is made to the credit used to reduce the taxpayer's 2010 tax liability.

### **Flow-Through Adjustments from Partnership Audits: The Recapture Amount**

The IRC §42(j) recapture amount is determined after the current year adjustment and any related adjustments to the carrybacks and carryforwards of credit are accounted for.

The maximum recapture amount will be determined when the partnership is audited. The adjustment at the partner level, however, may be less, depending on how the partner applied the credit against its tax liability.

When computing the recapture amount and computing any additional tax liability, consideration must be given to:

- The ordering rules under IRC §38 and the credit carryforward and carryback rules under IRC §39.
- The passive activity limitations under IRC §469.
- The alternative minimum tax under IRC §55.
- The Tax Benefit Rule under IRC §42(j) (4) (A).

### IRC §38 Ordering Rules

The IRC §38 ordering rules are demonstrated in the following example.

For 2007, the taxpayer claimed \$15,000 as an IRC §47 Rehabilitation Credit, which is included in the IRC §46 Investment Credit identified in IRC §38(b) (1) and reflected in column (b) in the chart below.

For 2008, the taxpayer claimed \$15,000 as an IRC §41(a) Research Credit, which is identified in IRC §38(b) (4), which is reflected in column (b) in the chart below.

For 2007 through 2011, the taxpayer's allowable IRC §42 credit from a partnership owning an IRC §42 project was \$50,000. The taxpayer used the IRC §42 credit to reduce its tax liability only after exhausting the allowable IRC §§ 47 and 41(a) credits as shown below.

(a) Credit Period Year	(b) Other Credits	(c) Tax Liability	(d) Other Credit Claimed	(e) Reduced Tax Liability	(f) IRC §42 Credit Allowable	(g) IRC §42 Credit Available	(h) IRC §42 Credit Claimed	(i) IRC §42 Credit C/F
2007	\$15,000	\$30,000	\$15,000	\$15,000	\$50,000	\$50,000	\$15,000	\$35,000
2008	\$15,000	\$50,000	\$15,000	\$35,000	\$50,000	\$85,000	\$35,000	\$50,000
2009		\$25,000		\$25,000	\$50,000	\$100,000	\$25,000	\$75,000
2010		\$52,000		\$52,000	\$50,000	\$125,000	\$52,000	\$73,000
Total					\$200,000		\$127,000	

Based on an audit of the partnership's 2011 tax return, there was a recapture event resulting in the total disallowance of the taxpayer's \$50,000 credit for 2011 and the recapture of accelerated credit in the amount of \$16,650 from each prior year; i.e., .333 x \$50,000.

Once the analysis of the ordering rules is completed, the tax benefit rule can be applied and recapture amount can be computed.

## Tax Benefit Rule

Under IRC §42(j) (4) (A), a tax benefit rule is applied to account for credit not used to reduce the partner's tax liability. The tax for the year the recapture is made is increased only with respect to credits allowed which reduced the taxpayer's tax liability.

Treas. Reg. §1.1016-3(e) (1) offers the following insight regarding the tax benefit rule:

[T]here are situations in which it is necessary to determine ... the extent to which the amount allowed ... resulted in a reduction for any taxable year of the taxpayer's taxes ... This amount (amount allowed which resulted in a reduction of the taxpayer's taxes) is hereinafter referred to as the "tax-benefit amount allowed."

For the purpose of determining whether the tax benefit amount allowed Exceeded the amount allowable, determination *must be made of that portion of the excess of the amount allowed over the amount allowable which, if disallowed, would not have resulted in an increase in any such tax previously determined. If the entire excess of the amount allowed over the amount allowable could be disallowed without any such increase in tax*, the tax-benefit amount allowed shall not be considered to have exceeded the amount allowable..."

[Emphasis added.]

The taxpayer must provide sufficient documentation to establish how the credits were applied. If the taxpayer cannot provide sufficient documentation, then the recapture amount will be computed as if the entire credit was used to reduce the taxpayer's tax liability in the year the credit was allowable.

## Applying the Tax Benefit Rule

The tax benefit rule is demonstrated in the following example.

A taxpayer owns a 25% interest in a partnership owning an IRC §42 project. Based on the Schedules K-1 received each year, the taxpayer claimed credit as shown in the following table.

The available credit is computed as the sum of the current year allowable credit (b) and the carryforward of credit from the previous year (f). The credit claimed (e) is the amount used to reduce the taxpayer's tax liability (d). The carryforward is the difference between the amount of credit available (c) and the amount of credit claimed (e).

(a) Credit Period Year	(b) Allowable IRC §42 Credit	(c) Available IRC §42 Credit	(d) Tax Liability	(e) IRC §42 Credit Applied Against Tax	(f) Carry Forward
2007	\$50,000	\$50,000	\$30,000	\$30,000	\$20,000
2008	\$50,000	\$70,000	\$50,000	\$50,000	\$20,000
2009	\$50,000	\$70,000	\$25,000	\$25,000	\$45,000

2010	\$50,000	\$95,000	\$52,000	\$52,000	\$43,000
Total	\$200,000			\$157,000	

Based on an audit of the partnership's 2011 tax return, there was a recapture event resulting in the total disallowance of the taxpayer's \$50,000 credit for 2011 and the recapture of accelerated credit from each prior year in the amount of \$16,650; i.e.,  $.333 \times \$50,000$ . After reducing the allowable credit in each prior year for the amount of the recaptured accelerated credit, apply taxpayer's remaining credit ( $\$50,000 - \$16,650 = \$33,350$ ) as if the disallowed accelerated credit had never been allowed.

(a) Credit Period Year	(b) Allowable §42IRS Credit	(c) Available IRC §42 Credits	(d) Tax Liability	(e) IRS §42 Credit Applied Against Tax	(f) Carry Forward
2007	\$33,350	\$33,350	\$30,000	\$30,000	\$3,350
2008	\$33,350	\$36,700	\$50,000	\$36,700	\$0
2009	\$33,350	\$33,350	\$25,000	\$25,000	\$8,350
2010	\$33,350	\$41,700	\$52,000	\$41,700	\$0
Total	\$133,400			\$133,400	

The entire accelerated credit to be accounted for is  $\$200,000 - \$133,400 = \$66,600$ .

To determine the amount of accelerated credit from which the taxpayer received tax benefit, subtract the corrected credit applied from the actual credit applied against tax in each prior year.

2007:  $\$30,000 - \$30,000 = \$0$

2008:  $\$50,000 - \$36,700 = \$13,300$

2009:  $\$25,000 - \$25,000 = \$0$

2010:  $\$52,000 - \$41,700 = \$10,300$

The taxpayer received benefit of \$23,600. The recapture amount is computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2007	April 15, 2008 - April 15, 2012	\$0	\$0	
2008	April 15, 2009 - April 15, 2012	\$13,300	\$3,029.00	\$16,329.00
2009	April 15, 2010 - April 15, 2012	\$0	\$0	
2010	April 15, 2011 - April 15,	\$10,300	\$420.24	\$10,720.24

	2012			
Total		\$23,600	\$3,449.24	\$27,049.24

The recapture interest under IRC §42(j)(2)(B) is computed at the overpayment rate established under IRC §6621 on the recaptured credit for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved. The interest rate is the federal short-term rate determined under subsection (b) plus 3 percentage points (2 percentage points in the case of a corporation). The flush language following IRC §6621(a) (1) is not applicable because there is no actual overpayment of tax.

The credit carryover must also be adjusted for the accelerated credit the taxpayer has not yet used to reduce its tax liability. The credit carryforward reported on the tax return was \$43,000. As corrected, the carryforward is zero. The adjustment to the credit carryforward is equal to \$43,000.

As a check, the recaptured credit and the disallowed credit carryforward must account for the entire amount of accelerated credit not allowable because of the recapture event. In this case:

$$\$23,600 + \$43,000 = \$66,600 = (.333) (\$50,000) \times 4 \text{ years}$$

The examiner will make three adjustments:

- The \$50,000 credit for the current year is disallowed.
- The \$43,000 credit carryforward is disallowed.
- The recapture amount equaling \$27,049.24, as an addition to tax.

If the taxpayer cannot substantiate the amount of credit used to reduce its tax liability in prior years, then the maximum recapture amount should be assessed, as computed below.

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2007	April 15, 2008 - April 15, 2012	\$16,650	\$4,903.63	\$21,553.63
2008	April 15, 2009 - April 15, 2012	\$16,650	\$3,384.00	\$20,034.00
2009	April 15, 2010 - April 15, 2012	\$16,650	\$1,641.69	\$18,291.69
2010	April 15, 2011 - April 15, 2012	\$16,650	\$679.32	\$17,329.32
Total		\$66,600	\$10,608.64	\$77,208.64

## Large Partnership Rule

The one exception to the tax benefit rule is the computation of the recapture amount when the partnership owning the IRC §42 project has 35 or more partners. Under IRC §42(j) (5), the partnership will be treated as the taxpayer for which the credit is allowable unless the partnership elects not to have the rule apply. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10b and is irrevocable.

If the taxpayer is a partner in a partnership subject to this rule, then the recapture amount is assessed against the partnership. The payment of the taxpayer's recapture amount by the partnership is income to the taxpayer and added to the taxpayer's capital account.

### **No Credit Against Recapture Amount**

Under IRC §42(j) (4) (D), the recapture amount is treated as an "increase" in or "addition" to tax. The recapture amount is not a "tax" against which any credit under Title 26, Subtitled A, Chapter 1, can be applied.

### **Disposition of Interest in Partnership Owning IRC §42 Project**

In the event a partner disposes of its partnership interest in a partnership owning an IRC §42 project, the taxpayer is not necessarily subject to recapture.

### **Dispositions After July 30, 2008**

IRC §42(j) (6) (A), as amended by the Housing Assistance Tax Act of 2008, provides that the credit recapture provisions are not applicable solely by reason of the disposition of an interest in a qualified low-income building if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period.

Instead, the taxpayer disposing of its interest in a low-income building remains subject to the credit recapture provisions should there be any reduction in the building's qualified basis resulting in the recapture of credit for the year of the disposition or any subsequent taxable year.

In addition, the taxpayer disposing of the low-income building (or interest therein) is required to notify the Secretary (IRS) if there is any reduction in qualified basis resulting in the application of the IRC §42(j) credit recapture provisions. The statutory period for the assessment of the credit recapture amount does not expire before the expiration of three years from the date the taxpayer notifies the IRS and such credit recapture amount may be assessed notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment. Rev. Proc. 2012-27 provides guidance for notifying the IRS.

### **Dispositions Before July 31, 2008**

If a taxpayer disposed its interest in a low-income building before the 2008 amendment, credit recapture could be avoided if two conditions were met:

- Under former IRC §42(j)(6)(B), the taxpayer reasonably expected that the building would continue to be operated as a qualified low-income building for the remainder of the 15-year compliance period, and
- Under former IRC §42(j) (6) (A), the taxpayer furnished the IRS with a surety bond in an amount satisfactory to the Secretary and for the period required by the Secretary.

Bonds were posted with the IRS using Form 8693, Low-Income Housing Credit Disposition Bond, according to instructions provided in Rev. Proc. 90-60. As an alternative, taxpayers were allowed to provide Treasury securities as collateral instead of a bond (see Rev. Proc. 99-11). The bond or collateral remained in effect until 58 months after the end of the 15-year compliance period.

An owner who disposed of its interest in a low-income building on or before July 30, 2008, and timely posted a bond or collateral may elect to be treated as if the disposition took place after July 30, 2008, which will result in the cancellation of the bond or return of the collateral. Instructions for making the election are included in Rev. Proc. 2008-60.

The IRS can "call a bond" to recapture credit if it subsequently determined that the new owner did not continue to operate the building as a qualified low-income building for the remainder of the compliance period.

### **Audit Issues and Techniques**

Did the taxpayer have a reasonable expectation that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? If not, the taxpayer is subject to the credit recapture provisions. The taxpayer will need to provide evidence that its expectation was reasonable.

Is the building actually being operated in compliance with IRC §42 requirements? The building's current status as a low-income building in compliance with IRC §42 requirements can be confirmed by contacting the housing agency that made the credit allocation. If not in compliance, then the taxpayer currently owning the IRC §42 project is subject to the IRC §42(j) credit recapture provisions.

- The audit should be expanded to include the tax returns of the related parties owning the IRC §42 project, or
- If it is not feasible to expand the audit, an information report should be submitted to the IRC §42 program analyst.

### **Example**

#### **Example 1: Taxpayer Timely Places Bond When Disposing of Partnership Interest**

A taxpayer disposed of its interest in a partnership owning an IRC §42 project on December 15, 2007, during the 5th year of the credit period. Instead of recapturing a portion of the credit claimed in tax years 2003-2006, the taxpayer posted a \$26,000 bond with the IRS.

The partnership's 2010 return was audited. The examiner determined a decrease in qualified basis, resulting in a \$100,000 maximum recapture amount. The taxpayer's portion, as a flow-through item, was \$23,500.

The IRS may "call" the bond for the entire \$23,500 recapture amount.

## **Summary**

This chapter addressed possible issues arising at the partner level; i.e., a partner in a partnership owning an IRC §42 project is audited.

Taxpayers file Form 8586, Low-Income Housing Credit, with their tax returns to claim the credit. The credit flowing through from the partnership will be reported on either line 4 or line 11, depending on when the low-income buildings were placed in service.

The IRC §42 credit is a General Business Credit identified in IRC §38(b) (5). The taxpayer will file Form 3800, General Business Credit, and report the IRC §42 credit in either Part I or Part II, depending on when the low-income buildings were placed in service.

Taxpayers claiming the IRC §42 as a flow-through item from a partnership owning an IRC §42 project are subject to the Required Filing Checks as outlined in IRM 4.10.5.4.

Under IRC §6222, partners are required to treat partnership items the same way as the partnership treated the items. Under IRC §6231(a)(6), "computational adjustments" can be made to a partner's tax return to properly reflect the treatment of a partnership item for a taxable year. These computational adjustments are commonly referred to as "true-ups." Taxpayers commonly use "year-to-year" true-ups to correct discrepancies in the amount of credit claimed. These true-ups are not an acceptable accounting method and an adjustment to the true-up is a change in accounting method.

The IRC §42 credit is subject to the IRC §38(d) ordering rules.

The IRC §42 credit is subject to the rules for carrybacks and carryforwards of unused credit under IRC §39.

The IRC §42 credit is subject to the passive activity limitations under IRC §469. Individuals file Form 8582-CR. Personal service corporations and closely held C corporations file Form 8810, Corporate Passive Activity Loss and Credit Limitations.

The IRC §42 credit is subject to limitations for purposes of the Alternative Minimum Tax (AMT) under IRC §55, if the building was placed in service before January 1, 2008. The limitation is accounted for on Form 3800, Part I. However, if the low-income building was placed in service after December 31, 2007, then the credit is not subject to the AMT limitation and the credit is accounted for on Form 3800, Part II. To compute the AMT, individuals use Form 6251 and corporations use Form 4626.

There are three possible adjustments related to changes in the allowable IRC §42 credit:

- Current year adjustment,
- Adjustment to any carryback or carryforward of credit, and
- Additions to tax for recapture amount.

There is a tax benefit rule under IRC §42(j) (4) (A) applied when determining the recapture amount.

If the partnership owning the IRC §42 project is a large partnership (35 or more partners), then the partnership is treated as the taxpayer to which the credit is allowable and the tax benefit is not applied when computing the recapture amount at the partnership level. However, the large partnership can elect not to be treated as a large partnership.

A partner may dispose of its interest in an IRC §42 project and not be subject to the IRC §42(j) credit recapture provisions if certain requirements are met. The rules differ based on the date of the disposition.

## **Chapter 20 Examination of Income**

### **Introduction**

The examination of income is a required issue for all tax returns selected for audit. Even if a partnership owning an IRC §42 project is selected for specific IRC §42 issues, the examination of income remains an audit requirement. Completion of the examination of income will also provide needed information for determining whether the owner is in compliance with the requirements of IRC §42.

### **Topics**

- IRM 4.10.4.3.3.1, Financial Status Analysis
- Balance Sheet Analysis
- Reconciliation of Schedules M-1 and M-2
- Related Parties
- Taxpayer Interview
- Tour the IRC §42 Project
- Internal Controls
- Reconciling Gross Receipts
- Business Ratio Analysis
- Summary

### **Reference**

IRM 4.10.4, Examination of Income

### **IRM 4.10.4.3.3.1, Financial Status Analysis**

While not required for partnership returns, a Financial Status Analysis (FSA) based on the rental schedule (Form 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation) included with the return can be helpful. The FSA is an evaluation of cash flows to estimate whether the taxpayer has sufficient funds to cover the known expenses. If possible, a three-year analysis should be completed. The key questions are:

- Is the rental activity generating a loss; i.e., are there more deductible expenses than income?
- If generating a loss, is it a "tax" loss caused by depreciation or another noncash expense?

If the loss represents a true imbalance of cash flows, i.e., more expenses paid than income reported, then the source of funds used to pay the bills and service debt should be identified. Negative cash flows are not suggestive that the business does not have a profit motive; i.e., under Treas. Reg. §1.42-4, the IRC §183 rules do not apply to qualified low-income buildings for which the IRC §42 credit is allowable.

### **Balance Sheet Analysis**

Analyzing accounts that have significantly changed and/or activity in an account may help explain how the taxpayer balances the cash flows. For example:

- Increase in capital accounts,
- Decrease in cash reserves or other assets,
- Accrual of short term liabilities,
- Postponement of payment on existing debt, and
- Increased or new debt.

For IRC §42 purposes, consider the postponement of payment on debt and increased debt. Key questions include:

- If the terms of existing debt are so favorable that the taxpayer can indefinitely postpone payment, then is it bona fide debt? Is the debt owed to a related third party? Is the debt amount fixed? Are the interest rate and repayment periods fixed? Has the taxpayer made payments in the past? Can it be anticipated that the taxpayer will ever be able to repay the debt?
- Does the debt represent a developer's fee? If the payment is conditioned upon the on-going compliance of the IRC §42 project, then the fee is a management fee and payments should be expensed.
- Does the debt support costs included in eligible basis? If debt is not bona fide debt, or is determined to be a current period cost, then the eligible basis will be affected.
- Is the debt federally sourced? See Chapter 10.

### **Reconciliation of Schedules M-1 and M-2**

Schedule M-1 includes entries that are not part of the taxpayer's double-entry accounting system. Normal account controls do not exist and errors may occur. Look for items that are deducted from the books and then erroneously deducted again on the Schedule M-1, transpositions of numbers, and expenses on the books but not on the tax return.

For Schedule M 2, changes in partners' capital accounts can indicate whether monies have been distributed to a partner and where those funds originated

## **Related Parties**

The partnership return and the partners' tax returns are considered related for audit purposes when the tax returns are for entities over which a partner has control and could possibly manipulate to divert funds or camouflage transactions. Audit techniques include:

- A review of the partnership agreement. This document will provide information regarding the rights, obligations, and powers of each partner.
- Because the general partner is frequently the entity that developed the property, review the terms of the development contract and any contracts for on-going management of the project.
- Identify transactions between the partnership and any individual or group of partners. If loans are made to the partnership from a partner, the source of the funds loaned should be evaluated.

## **Taxpayer Interview**

Specific to the reporting of taxable income, the taxpayer should be asked:

### **Rents**

- Who collects rents? Who makes deposits? Who reconciles the bank accounts? Who maintains the financial records?
- Regarding adequate supervision of employees, is there an on-site property manager or other employees?
- Because of the complex compliance requirements and potentially significant financial loss should noncompliance occur, it is quite likely that the limited partners (investors) will have some oversight authority. Ask the taxpayer if there have been any independent or internal audits. A review of the results can be helpful to identify issues and set both the scope and depth of the IRS audit.

### **Other Income Producing Activities**

- Are tenants paying any fees in addition to rent, and if so, what are the fees for?
- Is the taxpayer providing services in addition to housing?
- Is the taxpayer receiving any rent subsidies from any federal, state, local, or private source?
- Is the property being used for a commercial purpose that generates income?

## **Other Sources of Funds**

- Did the taxpayer receive any federal grants or federal subsidies during the tax year under audit?
- Have investors made additional contributions?
- Did the taxpayer receive any loan proceeds during the tax year under audit?

## **Tour the IRC §42 Project**

For purposes of the minimum income probes, touring the IRC §42 project serves three fundamental purposes:

### **Observing Business Practices**

Observing the taxpayer's business practices is particularly important to (1) evaluate the internal controls, (2) observe day-to-day operations, and (3) confirm information provided during the interview with the taxpayer. This is particularly important if a management company is operating the IRC §42 project.

- Observe the taxpayer's internal controls. How is rent collected, recorded, and deposited?
- Trace the transactions through the books and records to evaluate the reliability of the taxpayer's recordkeeping; i.e., do the books and records reflect actual operation?

### **Identify Potential Sources of Income**

In addition to the rent collected from households occupying the rental units, consider other sources that are not tenant specific. For example, vending machines in a laundry room or renting space for a radio or cell phone tower on the roof.

### **Confirm the Existence of Assets**

Although frequently reviewed and inspected by the state agencies, the IRC §42 housing should be toured to confirm that the project exists and is currently suitable for occupancy.

### **Internal Controls**

Internal controls are the taxpayer's policies and procedures used to identify, measure, and safeguard business operations and avoid material misstatements of financial information. As with all taxpayers, the evaluation must include gaining an understanding of the taxpayer's business practices and control features. Based on the results of that evaluation, the depth of the income probe can be established. See Chapter 3.

### **Reconciling Gross Receipts**

Reconcile the income per the books and records to the income reported on the tax return. Base the depth of the reconciliation on the reliability of the internal controls:

- Ask the taxpayer how income was computed and duplicate the taxpayer's steps.
- Even if the taxpayer uses double-entry books, reconcile the bank records. If loan proceeds or other non-rent deposits are identified, ask for verification of the source; e.g., loan documents.
- Confirm that income from all assets observed during the tour of the business is included in income.
- Trace specific transactions. Do the books account for each month that each unit was occupied? For tenants that pay by cash, how is cash handled and how timely is cash deposited?
- Based on the evaluation of internal controls, identify weaknesses which could be overridden or compromised, allowing for the diversion of income. Test weaknesses to determine whether income was actually diverted.

## **Business Ratio Analysis**

The initial reconciliation of income per the books and records to the tax return provides an understanding of how the taxpayer determined gross receipts. The books and records can also be used to evaluate the accuracy and reasonableness of the reported amount of income by analyzing ratios.

## **Horizontal Analysis**

The tax return under audit should be compared to the prior and subsequent year tax returns. Look for changes in key ratios or absolute numeric entries. Changes over time can be identified and may result in the identification of large, unusual, or questionable items that would not otherwise be apparent. For example, a significant decrease in the depreciation expense may indicate that an asset is no longer in service.

If the cost of the asset was included in eligible basis, the impact on the credit needs to be considered. Another example is a significant decrease in gross receipts, which may indicate that a significant number of vacant units are not being made available to the public for rent.

## **Vertical Analysis**

The tax return should be analyzed to identify differences between this taxpayer's business and the industry's standards for the year under audit. The purpose is to evaluate the reasonableness of the gross rents and net profit reported on the tax return.

Identifying a comparable industry standard is difficult, but IRC §42 offers an alternative. Instead of comparing the taxpayer's activities to industry standards, an analysis using the taxpayer's own analysis of anticipated operations can be completed.

Under IRC §42(m), the following information is available from the state agency that allocated the credit:

- A comprehensive market study of the housing needs of low-income individuals in the area to be served by the project (IRC §42(m) (1) (A) (iii)).
- Sources and uses of funds, as well as the total financing planned for the project (IRC §42(m) (2) (B) (i)).
- Anticipated developmental and operational costs of the project (IRC §42(m) (2) (B) (iv)).

The techniques discussed above can help determine whether the property is performing as anticipated. Significant deviation of actual costs and rental income from the anticipated amounts should be explained.

## **Summary**

Although the scope and depth may be limited, the Examination of Income is a required issue for all tax returns selected for audit because of specific IRC §42 issues.

The Examination of Income should include:

- A Financial Status Analysis based on the rental schedule,
- An analysis of the balance sheet,
- Reconciliation of Schedules M-1 and M-2,
- Consideration of related returns,
- Interviewing the taxpayer,
- Touring the IRC §42 project,
- Evaluating internal controls,
- Reconciling Gross Receipts, and
- Analysis of business ratios.